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Client Alert

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Baker & McKenzie

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For further information, please contact:

Greg McNab
+1 416 865 2311
greg.mcnab@bakernet.com

Jonathan D. Cocker
+1 416 865 6908
jonathan.d.cocker@bakernet.com

Matthew Grant
+1 416 865 2315
matthew.grant@bakernet.com

Introduction – Winds of Change

As a variety of governments and markets appear willing to implement new carbon management regimes, it is increasingly apparent that companies will be held accountable for environmental impacts of their business like never before. Recognizing this phenomenon, securities and accounting regulators and industry are putting pressure on issuers to adequately warn investors about environmental risks contained in their disclosure documents. It is also recommended that issuers ensure consistency in both their voluntary disclosures and mandatory regulatory filings.

Ontario Securities Commission ("OSC") *Staff Notice 51-716 - Environmental Reporting ("the Staff Notice")*, issued February 29, 2008, reminds reporting issuers of their environmental reporting obligations through continuous disclosure ("CD"). The OSC maintains that an adequate framework for environmental reporting currently exists within the management discussion and analysis ("MD&A") and annual information form ("AIF") document formats. Instead of overhauling environmental disclosure requirements, the OSC highlights where environmental reporting should be evident in existing CD documents, and points out, in a review of a sample of issuers, where many issuers fall short. The Staff Notice reinvigorates current CD obligations, which should satisfy investors pushing for heightened environmental disclosure, and push reporting issuers to ensure that their environmental disclosure is meaningful and thorough enough to meet expectations. To a lesser extent, the Alberta Securities Commission has raised similar concerns.

The Chartered Accountants of Canada are also offering guidance to help companies better disclose the business impacts of climate change to investors. The Canadian Institute of Chartered Accountants ("the CICA") has recently published two new documents in response to a growing demand for guidance relating to MD&A disclosures. The first, *Building a Better MD&A - Climate Change Disclosures*, helps companies provide useful and relevant information to investors. The second, *Executive Briefing – Climate Change and Related Disclosures*, points out that, at the company level, climate change is a business and shareholder value issue involving strategy, risk management and financial performance.

Finally, more closely akin to peer pressure than enforcement fear, several voluntary compliance organizations have found traction in the environmental and climate change disclosure arenas.

Securities Regulatory Guidance

Ontario Review

The OSC Staff Notice included a review of CD documents, including MD&A and AIF disclosure, for 35 reporting issuers (22 Toronto Stock Exchange listed companies and 13 TSX Venture Exchange listed companies) for whom the OSC is the principal regulator.

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Baker & McKenzie LLP
Toronto Office
181 Bay Street, Suite 2100
Toronto, ON Canada M5J 2T3

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The review also contrasted available CD documents with the disclosure on each company's website. While the issuers examined operate in environmental services, industrial products, mining, oil and gas, steel, transportation services, or utilities related industries, the OSC emphasized that its commentary would be relevant to any industry.

OSC Staff Notice Environmental Disclosure Requirements

In CD documents, such as the MD&A and AIF forms, "materiality" is the determining factor for inclusion.[1] Information relating to environmental matters is likely material if a reasonable investor's decision whether or not to buy, sell or hold securities of the issuer would likely be influenced or changed if the information was omitted or misstated.[2] According to the OSC, both qualitative and quantitative factors should be considered in determining materiality for disclosure relating to environmental matters.

The OSC notes that certain environmental matters are likely to be material and require disclosure. These include:

- environmental liabilities
- asset retirement obligations
- financial and operational effects of environmental protection requirements
- environmental policies fundamental to operations
- environmental risks

In order to fulfill CD obligations, issuers will need to include meaningful disclosure on the above matters, including analysis that goes beyond boiler plate discussions. To help clarify the extent of the disclosure expected of issuers, the OSC includes examples of best practices for each type of disclosure.

1. Environmental Liabilities

Estimating environmental liabilities can involve uncertainty, which is why Canadian generally accepted accounting principles ("GAAP") allow the minimum estimate to be accrued where no estimate is more likely than any other. However, if an environmental liability involves an estimate, management of reporting issuers are required to discuss estimates and include an analysis in their MD&A.[3] In its analysis, management should:

- identify and describe each estimate, including methodology and assumptions, while reflecting on any current trends and explain why the estimate may change in the future
- explain the significance of the estimate, in particular by identifying financial statement line items affected by it
- discuss changes to the estimate during the past two financial years
- identify and discuss the segment of the business that the estimate will effect

1 MD&A Form 51-102F1 Part 1(f) and AIF Form 51-102F2 Part 1(e).
2 This concept of materiality is consistent with the financial reporting notion of materiality included in the Canadian Institute of Chartered Accountants Handbook.
3 Required by 1.12 of Form 51-102F1.

The OSC views the inclusion of a discussion of materially contingent environmental liabilities in an issuer's MD&A and/or AIF as necessary, whether or not the liability has been accrued in the financial statements or mentioned in the notes to the financial statements.

OSC Best Practice Example: *One issuer in the study, in discussing reclamation costs, stated that its operations are subject to environmental laws in the various countries where it has closed mines and open mines. The issuer then stated that technical issues made the reclamation of closed mines uncertain, which, together with any future changes in environmental laws, made estimating reclamation costs difficult. Nevertheless, the issuer provided a breakdown of its estimated reclamation costs for its closed mines and its open mines, and provided the basis and methodology for making these estimates. The issuer concluded its analysis by noting that it recognized changes in its estimated reclamation costs immediately for closed mines and amortized any changes in its estimated reclamation costs over the life of its open mines.*

2. Asset Retirement Obligations ("AROs")

ARO's can impose significant environmental and economic burdens on an issuer. As soon as a reasonable estimate can be made, the OSC notes that AROs should be included in an issuer's financial statements. Further analysis of an issuer's financial condition, results of operations and cash flows, which includes a discussion of commitments, events or uncertainties that are reasonably likely to have an effect on the issuer's business, should be part of an issuer's MD&A.

OSC Best Practice Example: *One issuer in the study accrued environmental remediation costs relating to certain mines in its annual financial statements in accordance with GAAP. The issuer also included a comprehensive discussion of these costs in its MD&A and AIF, separating the costs into categories such as the costs of compliance with environmental legislation and the costs associated with the disposal of hazardous materials, and also divided the costs among open mines, closed mines and development projects. The issuer then identified the current and future impact of the costs on financial results and noted that it would record a loss accrual if a contingent loss arose due to the improper use of an asset and the loss was probable and could be reasonably estimated.*

3. Financial and Operational Effects of Environmental Protection Requirements

Changing environmental protection requirements can create significant compliance costs for companies. The OSC reminds companies that they must disclose in their AIF how environmental protection requirements will affect the companies capital expenditures, earnings and competitive position.[4] This type of analysis, when it includes assigned value estimates, can be valuable to investors trying to select companies which are planning to adapt to future requirements.

OSC Best Practice Example: *One issuer in the study did include a detailed discussion of the financial and operational effects of environmental protection requirements on their capital expenditures, earnings and competitive position in the current financial year and the expected effect in future years. For example, it stated that it designs and operates in compliance with all applicable environmental requirements relating to the protection of the environment. The issuer*

4 Form 51-102F2 (item 5.1(1)(k)).

also stated that it cannot predict the changes that could be made to environmental requirements in the future. The issuer concluded its discussion by stating that its capital and operating costs for environmental controls would likely increase in the future, but these increases were not expected to have a material effect on the earnings or competitive position of the issuer.

4. Environmental Policies Fundamental to Operations

Environmental policies fundamental to operations must be described in an issuer's AIF.[5] Thoughtful analysis on how internal policies affect financial performance can demonstrate an issuer's commitment to voluntary controls and may predict its ability to balance new protection requirements or take advantage of voluntary market credits. The OSC stresses the need to disclose, whenever possible, the costs associated with the policies and their affects on operations.

OSC Best Practice Example: *One issuer discussed its various programs to prevent and control spills and protect water quality, reuse and conserve water, and mitigate the dust produced by its operations for each of its properties. The issuer also addressed how harmful materials generated by its operations are removed and destroyed, and described its policy of performing regular environmental audits on all of its properties.*

5. Environmental Risks

Issuers are required to disclose and discuss, in their AIF and/or MD&A, risk factors, including environmental risks, associated with their business. The OSC is of the view that risks relating to the cost of compliance with applicable national and international laws should be discussed and analyzed by issuers. As greater market and reputational consequences flow from an issuer's compliance, an issuer's own assessment of the environmental risks is an important factor for investors to consider.

OSC Best Practice Example: *One issuer provided a detailed discussion of the foreign environmental laws and regulations that apply to it and quantified the costs of compliance with these laws and regulations in both the short- and long-term. The issuer also discussed how significant changes to these laws or regulations could materially impact its expenditures, which in turn could affect its business, financial results and financial condition.*

6. Certification and the Role of Audit Committees

In addition to clarifying existing environmental reporting requirements, the OSC also restated the role of certifying officers and audit committees in ensuring that CD documents such as the MD&A and AIF fairly represent, in all material respects, the financial condition of the issuer. This is a not so subtle reminder to certifying officers and directors that they have a role in ensuring that issuer CD documents meet environmental disclosure expectations.

Alberta Review

On February 16, 2007 the Alberta Securities Commission ("the ASC") published its report entitled "Disclosure Review Program" which focused on the 2006 review of financial statements; MD&A and other continuous disclosure material. Among other things, ASC Staff found boilerplate risk language disclosure found in AIF and MD&A disclosure, including the description of a reporting issuer's environmental policies,

5 Form 51-102F2 (item 5.4).

environmental protection requirements, and exposure to environmental risk and critical accounting estimates in respect of environmental liabilities. ASC Staff encouraged reporting issuers to improve their environmental disclosure by increasing specificity of any environmental risks likely to effect the reporting issuer.

Accounting Regulatory Guidance

The CICA's recent guidance updates its previous guidance on the topic of environmental disclosure. The materiality standard for disclosure for these purposes is consistent with that contained in the CICA Handbook. In a 2005 discussion brief, *MD&A Disclosure about the Financial Impact of Climate Change and Other Environmental Issues*, the CICA stated, "Climate change and other environmental issues should be disclosed and discussed if they either have, or are reasonably likely to have, a current or future effect, direct or indirect, on the entity's financial condition, changes in financial condition, results of operations, liquidity, capital expenditures or capital resources that is material to investors."

Building a Better MD&A, Climate Change Disclosures updates that 2005 CICA Discussion Brief and is quite direct in its description of the potential impact of climate change on Canadian companies. It states:

> "Climate change issues will impact some industries and companies more than others. But sooner or later climate change will affect, either directly or indirectly, the business operations and financial performance of many Canadian companies, large and small, in most sectors."

As a result, there is a need for companies that are potentially affected by climate change to provide timely and appropriate environmental related disclosure. The CICA notes that the challenge facing most companies lies in determining what information to disclose and under what circumstances to disclose. The CICA's guidance echoes many of the same concerns of securities regulators set out above.

For example, securities regulators look to disclosure set out in a company's MD&A and/or its AIF. However, a company may have also disclosed environmental information in its sustainability report, corporate website or in its responses to surveys such as the annual survey conducted by the Carbon Disclosure Project (discussed below). If disclosure is not made in a company's MD&A or its AIF, investors may actually interpret that to mean that the information is not material. The challenge lies in balancing the availability of reliable climate change information with the informational needs or demands of investors, bearing in mind that different methods of disclosure are subject to different levels of oversight.

The CICA's information is largely based upon input from institutional investors and market analysts. It found that these persons increasingly want information that will enable them to assess the impact of climate change to a company, as was evidenced by a 2007 petition to the U.S. Securities Exchange Commission ("SEC") by a broad coalition of investors encouraging the SEC to compel publicly traded companies to improve their climate change disclosure. The CICA focused on and attempted to answer several key questions:

- What topics do investors want information on?
  - business strategy
  - risks
  - actual greenhouse gas emissions
  - financial impacts
  - governance processes.
- What information should a company disclose and how should it be presented?
  - information regarding short-term and long-term impacts
  - consistency with prior disclosures
  - information regarding the variability of possible outcomes
- What questions can a company ask itself regarding climate change disclosure?
  - How has the company determined which climate change issues are material and disclosed in MD&A? Has materiality been assessed in both quantitative and qualitative terms?
  - Has the company addressed the potential impact of climate change issues on both its short-term and long-term financial condition and performance?
  - From period to period, is there comparability and consistency in MD&A disclosures about climate change?
  - Has the company ensured consistency of MD&A climate change disclosures with those in other public reports it has issued?
  - Has the company implemented appropriate systems, procedures and controls to enable timely, complete and reliable reporting of climate change information in MD&A?

Other Climate Change Disclosure Initiatives

Investor activists have taken specific additional initiatives to increase climate change disclosure by issuers. In October 2006, the Global Framework for Climate Risk Disclosure was established by a group of leading institutional investors. It set out principles and information that investors often consider when analyzing an investment's climate risks, including the investment's current and historical green house gas emissions, its climate change policy and any corporate and operational steps it has taken to reduce identified risks. This voluntary framework encourages companies to engage in the disclosure of this information through mandatory financial reporting (described above) and voluntary reporting mechanisms, such as the *Carbon Disclosure Project*[6] ("CDP") and *Global Reporting Initiative*[7] ("GRI").

The CDP now represents investors with over US$57 trillion in assets under management, including major Canadian financial institutions and pension plans. Some of the world's largest companies have answered Developments in Climate Change Disclosure Requirements annual questionnaire, including 202 of Canada's largest companies based on market capitalization, for its fifth report, CDP5 in 2007, and similarly 190 companies in its sixth report, CDP6 in 2008. Also earlier in 2008, three large U.S.

6 For further information, see: http://www.cdproject.net/aboutus.asp
7 For further information, see: http://www.globalreporting.org/Home
8 For further information, see: http://carbonprinciples.org

banks, Citi, JPMorgan Chase and Morgan Stanley, announced *The Carbon Principles*[8] to provide guidance to energy companies in managing carbon risks. These principles result from a nine-month consultation with seven of the largest power companies in the U.S. The principles include greater emphasis on energy efficiency and renewable/low-carbon energy technologies, as well as better risk analysis for conventional forms of energy generation. This effort sets the stage for the development of a consistent approach among major lenders and advisers in evaluating climate change risks and opportunities in the U.S. electric power industry, and could ultimately be emulated across other sectors in the near future.

Voluntary initiatives like the ones discussed above typically propose that issuers deal with the following aspects of their business:

- measure their "carbon footprint"
- analyze the risks, challenges and opportunities presented by climate change
- manage these risks and opportunities.

Conclusion

In focusing on environmental disclosure, regulators, accountants and industry are preparing reporting issuers for an era where environmental matters, such as green house gas emissions, directly affect performance and share price. Regulators are clear that website disclosure on environmental policies and risks is not sufficient. Environmental matters must be considered alongside other material matters in an issuer's CD documents. There is no indication that regulators plan any extra enforcement over environmental reporting. However, there is recognition that there will be market consequences for issuers who fail to stay current with environmental compliance and risks. It is becoming harder to resist the position that investors have a right to full disclosure on environmental matters so they can make their own informed investment decisions.

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